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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of : 93-50

The Allowance For Funds Used During Construction (AFUDC) Rate Properly Charged By Dominant Carriers For Ratemaking And Other Purposes : RM-7626

REPLY COMMENTS OF THE AMERITECH OPERATING COMPANIES

In a petition for rulemaking, the Ameritech Operating Companies[1] requested that the Commission modify the existing rule governing the Allowance for Funds Used During Construction (AFUDC) rate from the "prime rate" to the Commission-authorized return -- unless the Commission decides to include long-term plant under construction (PUC-LT) in the rate base. Of the five parties commenting on the petition,[2] only MCI opposes Ameritech's proposal. Its opposition exhibits a failure to understand basic ratemaking principles and lacks on reasoned analysis. NYNEX, while supporting a rulemaking, suggests an alternative to Ameritech's proposal. The NYNEX alternative, however, proceeds from a misconception about Generally Accepted Accounting Principles

1. The Ameritech Operating Companies are Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, The Ohio Bell Telephone Company, and Wisconsin Bell, Inc.

2. These commenters are USTA, BellSouth, Southwestern Bell, the NYNEX Telephone Companies and MCI Telecommunications Corp. (MCI).

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(GAAP) and the Commission's Rules. Ameritech respectfully files these reply comments in response to MCI's opposition and NYNEX's alternative.

MCI's Opposition Rests On A Series of Misstatements.

MCI's misstatements and failure to comprehend the relevant ratemaking principles makes a coherent response difficult -- except to systematically point out MCI's mistakes.

MCI Misstatement: Ameritech proposes to charge current customers AFUDC by including AFUDC in the "current rate base." MCI Opp. 2, 3, 4.[3]

The Facts: Ameritech's proposal would not include AFUDC in the "current rate base." Current ratepayers would not bear current AFUDC costs. With respect to a particular construction project, the accumulated AFUDC is not reflected in a capital account until that project is transferred to plant in service (Account 2001). The carrier then begins recovering the AFUDC amount by depreciating the amount in Account 2001, including the credited AFUDC amount. The Court and Commission understand this timing, even if MCI does not:

3. MCI Opp. at 2 ("Ameritech also proposes that AFUDC amounts be included in the current rate base as if such capitalized interest were part of TPIS."); MCI Opp. at 3 ("Ameritech proposes that AFUDC, which is clearly a cost of future construction, be included in the current rate base."); MCI Opp. at 4 ("Basically, Ameritech now suggests that it receive from current ratepayers, the prescribed rate of return . . ..").

> Upon completion of the plant, the AFUDC is transferred to the rate base along with the cost of the plant, and recovered through the charge for depreciation.[4]

Not only did the Court and the Commission explain how AFUDC works, Ameritech's petition contained a table that shows that current ratepayers do not bear a single penny of AFUDC costs while plant is under construction. Ameritech Pet., Att. A at 2.

Ameritech's petition requests a change in the AFUDC rate. It does not request a change in the timing for recovering capitalized AFUDC.

MCI Misstatement: Ameritech's proposal is a "radical departure" from the Commission's "well established" and "time honored" policy of using the prime rate as to AFUDC rates.[5] MCI Opp. 1-2, 4, 8.

The Facts: Setting the AFUDC rate at the prime rate is neither "well established" nor "time honored," and Ameritech's proposal hardly qualifies as a "radical departure" from "established policy." Until the 1977 AT&T rate case, the Commission's policy was to include PUC-LT in a carrier's rate base,[6] thus for 44 years the Commission had no occasion to set an AFUDC rate. Only in the 1977 AT&T case and in the Comsat

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4. *Illinois Bell Tel. Co. v. FCC*, 911 F.2d 776, 782 (D.C. Cir. 1990), *citing Rate Base Reconsideration Order*, 4 FCC Rcd 1696, 1703 ¶ 54 (1989).

5. MCI Opp. at 1-2 ("The Commission's well established and reconfirmed policy is for AFUDC to be computed using the 'compound prime rate of interest.'"); MCI Opp. at 4 (The proposed "Ameritech . . . modification . . . is a radical departure from the Commission's established policy."); MCI Opp. at 8 ("In a final attempt to establish some reason for the Commission to change its time-honored policies, Ameritech asserts . . ..").

6. *See American Tel. & Tel. Co.*, 9 F.C.C.2d 960, 972 ¶ 45 (1967). In 1977, the FCC rejected an ALJ decision to include PUC-LT in the rate base. *American Tel. & Tel. Co.*, 64 F.C.C.2d 1, 56-60 ¶¶ 140-154 (1977).

rate case[7] did the Commission attempt to justify setting the AFUDC rate at the prime rate, and in *Comsat* the D.C. Circuit set aside that determination. *Communications Satellite Corp. v. FCC*, 611 F.2d 883, 895-97 (D.C. Cir. 1977).

One unreviewed decision hardly qualifies as a "well established" policy particularly when (a) a similar determination was reversed on judicial review, and (b) the Commission's current rules provide otherwise. Section 32.2000(c)(2)(x), which was adopted in 1987,[8] states that AFUDC "includes the *cost of debt and equity funds* used in the construction of telecommunications property . . .." 47 C.F.R. § 32.2000(c)(2)(x) (emphasis supplied). The prime rate does not purport to incorporate even the minimum cost of equity capital.

MCI Misstatement: "Ameritech has grossly misinterpreted the court and Commission decisions on the reasonable amount of interest that would be allowable . . .." MCI Opp. at 5. "In choosing the prime rate [in Docket No. 19129], the Commission did not base its decision upon, nor was it required to consider, the actual funding used by AT&T." MCI Opp. at 6.

The Facts: The Commission, to be sure, did not adopt the prime rate in the AT&T case based on AT&T's actual funding. No one ever said it did. The use of the prime rate was predicated on the Commission's express finding that AT&T could finance its construction program with short-term debt, which the Commission further found AT&T

7. *Communications Satellite Corp.*, 56 F.C.C.2d 1101 (1975).

8. *Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies*, 2 FCC Rcd 1086 (1987), *recon.*, 2 FCC Rcd 6555 (1987).

could borrow at the prime rate. *American Tel. & Tel. Co.*, 64 F.C.C.2d at 59-60 ¶ 150. No similar finding was made with respect to the LECs. Moreover, AT&T did not request review of that decision.

When, however, the FCC adopted the prime rate as the AFUDC rate for Comsat, the Court reversed. The Court reversed even though the Commission found that the prime rate exceeded Comsat's anticipated future financing costs. As Comsat was 100% equity financed at the time, the Commission assumed that debt would be used to raise additional funds. The Commission also found that Comsat could finance construction projects using long-term bonds at an interest rate which was less than the prime rate. Thus, the Commission believed the prime rate was generous. *Comsat*, 56 F.C.C.2d at 1173 ¶ 305.

The D.C. Circuit overturned that determination because the Commission failed to use its best "'judgment as to the most realistic assumption' about the source of capital" in selecting the AFUDC rate.[9] The Court subsequently explained the reason for that standard: "AFUDC is intended to compensate investors for the use of their funds during construction" when PUC-LT is excluded from the rate base. *Illinois Bell*, 911 F.2d at 782. The funds -- the source of capital -- include both debt and equity. Therefore, the carrier is entitled to an AFUDC rate that reflects both sources:

> A regulated utility is, of course, entitled to recover the cost of financing the construction of facilities. . . . The

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9. FCC Brief at 32, *Illinois Bell v. FCC*, 911 F.2d 776 (1990) (D.C. Cir.) (No. 88-1175), *quoting Comsat*, 611 F.2d at 895 (emphasis supplied).

> "cost" includes interest on debt and a reasonable return on capital investment.[10]

In short, the Ameritech proposal, and not the use of the prime rate, is consistent with the Court's, the Commission's and Commission Counsel's understanding as to the purpose of AFUDC. The 1977 AT&T decision, in contrast, is an isolated aberration.

MCI Misstatement: "Ameritech has essentially proposed its own definition of the 'full cost' of capital, and then tries to attribute that definition to the Commission." MCI Opp. at 7.

The Facts: The FCC defined the full cost of capital in its *Rate of Return Prescription Order*.[11] Ameritech's comments in that proceeding "defined" the full cost of capital as 13.0%, not the 11.25% return ultimately authorized by the Commission. The "correct figure" is beside the point, however. The relevant facts are (a) MCI refuses to recognize that equity capital is used to finance construction programs, and (b) equity, like debt, has a cost.

MCI Misstatement: "The prescribed rate of return . . . bears no relationship to the actual funding of long-term construction, and would also unduly compensate LECs for inappropriate funding." MCI Opp. at 7.

The Facts: MCI's statement is simply not true, and ignores the proofs set out in Ameritech's petition. Ameritech documented that equity and debt funds are used to finance construction projects. It showed that

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10. *Mid-Tex Electric Cooperative, Inc. v. FERC*, 773 F.2d 327, 330-331 (D.C. Cir. 1985).

11. *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, 5 FCC Rcd 7507 (1990) (*Rate of Return Prescription Order*).

the proportion of debt and equity used to fund projects closely parallels Ameritech's existing capital structure. Ameritech Pet. at 7-8.

MCI leaves to everyone's imagination how setting the AFUDC rate at the prescribed return level would "unduly compensate the LECs." Is MCI suggesting that depreciation funds should not be used to finance construction? About 95% of current construction is financed that way. If MCI believes that such financing is improper, its belief is at odds with the Commission's recent encouragement that the LECs reinvest capital recovered through depreciation in the infrastructure.[12]

An AFUDC rate set at the prime rate would discourage such reinvestment. If a LEC cannot earn a return equal to the cost of capital on reinvested funds, it has no incentive to reinvest depreciation dollars in long-term construction projects.

NYNEX's Alternative, Not Ameritech's Proposal, Is Inconsistent With GAAP Principles And Sound Economics.

Citing the Statement of Financial Accounting Standards (FAS) No. 34, NYNEX proposes an AFUDC rate intended for non-regulated companies. According to NYNEX, that rate -- which is based on potentially avoided interest -- is required by generally accepted accounting principles (GAAP). NYNEX is wrong. For regulated companies, both the Financial Accounting Standards and GAAP affirmatively approve using an AFUDC rate based on a combination of

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12. *Rate of Return Represcription Order*, 5 FCC Rcd at 7530 ¶ 203; *see also* "FCC Announces 'Price Caps' Schedule and Continues Interim Rate of Return (Docket No. 87-463)," Report No. DC-1532 (News Release, Dec. 21, 1989) and accompanying statement of Chairman Alfred C. Sikes.

debt and equity costs. As the accounting profession recognizes, FAS 34 procedures make no economic sense for rate-regulated companies.

FAS 71 expressly points out that ratemaking agencies take into account that construction is "financed partially by borrowings and partially by equity" in setting an AFUDC rate. FAS 71 ¶ 15 (copy attached). FAS 71 goes on to provide that --

> In such cases, the amounts capitalized for rate-making purposes . . . shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.

In other words, Ameritech's proposal is consistent with GAAP.[13]

Moreover, Ameritech's proposal is consistent with the FERC practice and its interpretation of GAAP is consistent with the understanding of both courts and commissions. In *ARCO Pipe Line Co.*, 52 FERC ¶ 61,055 (1990), the FERC reinforced that it "permits the capitalization of AFUDC (*i.e.*, both interest and equity) into rate base."[14] And, the "equity rate of return embedded in the AFUDC rate should be the equity rate of return in effect at the time of the construction of the facilities."[15]

The FERC has no doubt that its treatment is consistent with GAAP. Nor do the courts. For example, *In re Public Service Co. of New Hampshire*, 114 B.R. 820 (D.N.H. 1990), involved the issue whether the

13. *See also* FAS 90 ¶ 8 (copy attached).

14. *ARCO Pipe Line Co.*, 52 FERC at 61,234.

15. *ARCO Pipe Line*, 52 FERC at 61,244.

utility's (PSNH) accounting practices complied with GAAP. The Court concluded that an AFUDC rate based on debt and equity costs complied with GAAP (114 B.R. at 837):

> In reporting the value of its investment in Seabrook, PSNH was bound by Generally Accepted Accounting Principles ("G.A.A.P."). . . . When a power plant is accounted for under FAS-71, the plant construction costs and an allowance for funds used during construction ("AFUDC"), which represents a reasonable return on both the debt and equity invested into the project, are added into the cost of the asset and capitalized on the utility's balance sheet. (Emphasis supplied).

In addition, NYNEX's proposal makes no sense for regulated entities. In the non-regulated world, earnings levels are not restrained: No commission exists to "protect" current customers of the non-regulated entity from bearing the cost of assets that are not presently "used and useful." No requirement is imposed on the non-regulated firm to construct facilities to meet anticipated needs even if the anticipated incremental revenues generated by the new facilities will not cover the additional costs. Non-regulated firms are always in a profit-maximizing mode.

In contrast, the LEC's earnings are constrained[16] and it must construct facilities to meet anticipated service demands even though the

16. Even the price cap plan for LECs establishes maximum return levels and a mechanism for enforcing these earning constraints. For price cap carriers the setting of the AFUDC rate at the prescribed return level should be accomplished by an exogenous adjustment.

additional revenues will not cover the additional costs.[17] That constraint and that obligation means that utility investors will be denied an opportunity to recover their cost of capital over time if the AFUDC rate fails to reflect a proportionate share of the equity capital devoted to long-term plant under construction. A rule which systematically inhibits a carrier's ability to recover its capital costs is unlawful. *American Tel. & Tel. Co. v. FCC*, 836 F.2d 1386, 1390-91 (D.C. Cir. 1988).

CONCLUSION

For the foregoing reasons, and for the reasons set out in the petition, the Commission should initiate a rulemaking proceeding proposing to adopt the Commission's prescribed or authorized rate of return as the AFUDC rate.

Respectfully submitted,

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17. *See, e.g., Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1171 (D.C. Cir. 1987) ("Regulated public utilities are under statutory obligations to plan and build the facilities necessary to meet the projected needs of their customers.")

ATTACHMENTS

Statement of Financial Accounting Standards No. 71 Accounting for the Effects of Certain Types of Regulation

STATUS

Issued: December 1982

Effective Date: For fiscal years beginning after December 15, 1983

Affects: Supersedes ARB 44 (Rev.), paragraphs 8 and 9
Amends ARB 51, paragraph 6
Supersedes APB 1, paragraph 7
Supersedes APB 2, paragraph 17 and Addendum
Supersedes APB 6, paragraph 20
Amends APB 11, paragraph 6
Supersedes APB 16, paragraph 6
Supersedes APB 17, paragraph 7
Amends APB 20, paragraph 3
Supersedes APB 23, paragraph 4
Supersedes APB 24, paragraph 3
Amends APB 26, paragraph 2
Amends APB 29, paragraph 4
Supersedes AIN-APB 8, Interpretation No. 22
Amends AIN-APB 11, Interpretation No. 4
Supersedes FAS 2, paragraph 14
Supersedes FAS 4, paragraph 7
Supersedes FAS 5, paragraph 13
Amends FAS 7, paragraph 5
Supersedes FAS 13, paragraph 3
Supersedes FAS 15, paragraph 9
Supersedes FAS 16, paragraph 9
Supersedes FAS 19, paragraph 9
Supersedes FAS 22, paragraph 11
Supersedes FAS 34, paragraph 5
Supersedes FAS 43, paragraph 3
Supersedes FAS 49, paragraph 7
Supersedes FAS 51, paragraph 2
Supersedes FIN 18, paragraph 4
Supersedes FIN 22, paragraph 8
Supersedes FIN 25, paragraph 9

Affected by: Paragraph 9 amended by FAS 90 and FAS 92
Paragraph 10 amended by FAS 90
Paragraph 13 superseded by FAS 90 and FAS 92
Paragraph 14 superseded by FAS 92
Paragraph 15 amended by FAS 90
Paragraph 18 and footnote 12 superseded by FAS 96
Paragraph 34 amended by FAS 90
Paragraph 46 amended by FAS 96
Footnote 6 superseded by FAS 90

Other Interpretive Pronouncement: FTB 87-2 ment No. 5, *Accounting for Contingencies*, shall be recorded as liabilities and as reductions of revenue or as expenses of the regulated enterprise.

b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose,[8] the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred.

c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated enterprise shall not recognize that gain or other reduction of net allowable costs in income of the current period. Instead, it shall record it as a liability for future reductions of charges to customers that are expected to result.

12. Actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator.

13. Appendix B illustrates the application of the general standards of accounting for the effects of regulation.

Specific Standards Derived from the General Standards

14. The following specific standards are derived from the general standards in paragraphs 9-12. The specific standards shall not be used as guidance for other applications of those general standards.

Allowance for Funds Used during Construction

15. In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.[9] The income statement shall include an item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized.

Intercompany Profit[10]

16. Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements[11] if both of the following criteria are met:

a. The sales price is reasonable.
b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

17. The sales price usually shall be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness shall be considered in light of the circumstances. For example, reasonableness might be judged by the return on investment earned by the manufacturing or construction operations or by a comparison of the transfer prices with prices available from other sources.

Other Specific Standards

Accounting for Income Taxes

18. Items of revenue and expense are sometimes

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[8] The usual mechanism used by regulators for this purpose is to require the regulated enterprise to record the anticipated cost as a liability in its regulatory accounting records.

[9] Statement 34 requires capitalization of interest cost on certain qualifying assets. The amount capitalized is the portion of the interest cost incurred during the period that theoretically could have been avoided if the expenditures had not been made.

[10] The term *intercompany profit* is used in this Statement to include both profits on sales from one company to another within a consolidated or affiliated group and profits on sales from one operation of a company to another operation of the same company.

[11] ARB No. 51, *Consolidated Financial Statements*, requires that profit on sales of assets remaining in the consolidated group be eliminated in consolidated financial statements. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, effectively extends that requirement to affiliated entities reported on the equity method.

Statement of Financial Accounting Standards No. 90
Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs

an amendment of FASB Statement No. 71

STATUS

Issued: December 1986

Effective Date: For fiscal years beginning after December 15, 1987 and interim periods within those fiscal years

Affects: Amends FAS 71, paragraphs 9, 10, 15, and 34
Supersedes FAS 71, paragraph 13 and footnote 6

Affected by: Paragraph 9(d) superseded by FAS 92
Paragraphs 14 and 27 amended by FAS 96
Paragraphs 16 through 25 superseded by FTB 87-2

Other Interpretive Pronouncement: FTB 87-2

SUMMARY

This Statement amends FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* for two types of events that recently have occurred in the electric utility industry—abandonments of plants and disallowances of costs of recently completed plants.

This Statement amends Statement 71 to require the future revenue that is expected to result from the regulator's inclusion of the cost of an abandoned plant in allowable costs for rate-making purposes to be reported at its present value when the abandonment becomes probable. If the carrying amount of the abandoned plant exceeds that present value, a loss would be recognized. Statement 71 previously required that asset to be reported at the lesser of the cost of the abandoned plant or the probable gross revenue.

This Statement also amends Statement 71 to require any disallowed costs of a recently completed plant to be recognized as a loss. Statement 71 previously required asset impairments to be recognized but did not specify what constitutes an impairment or provide specific guidance about how impairments should be measured.

Finally, this Statement amends Statement 71 to specify that an allowance for funds used during construction should be capitalized only if its subsequent inclusion in allowable costs for rate-making purposes is probable.

This Statement is effective for fiscal years beginning after December 15, 1987 unless (a) application of the Statement would cause a violation or probable future violation of a restrictive clause in an existing loan indenture or other agreement and (b) the enterprise is actively seeking to obtain modification of that restrictive clause. In that case, this Statement is effective for fiscal years beginning after December 15, 1988.

This Statement applies to the recorded costs of previously abandoned assets, the recorded costs of assets for which future abandonment is probable or becomes probable in the future, previously disallowed plant costs, and disallowances of plant costs that are probable or become probable in the future. Restatement of financial statements for prior fiscal years is encouraged but not required.

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[2]Interpretation

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of April, 1991, a copy of the foregoing "Reply Comments Of The Ameritech Operating Companies" was served by first class United States mail, postage prepaid, upon the parties set forth on the attached Service List.

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Dated: April 5, 1991

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